Committee of European Banking Supervisors

CEBS

20 April 2010

CEBS's comments on the Commission services'

Consultation Paper on further possible changes to the Capital Requirements Directive (CRD IV)

1. CEBS welcomes the opportunity to comment on the Commission services' Consultation Paper on further possible changes to the Capital Requirements Directive (CRD IV).
2. CEBS's comments focus on the sections on liquidity standards, definition of capital, leverage ratio and countercyclical measures and are presented in the following sections of this note.
3. CEBS would like to make clear that although it does not comment on several of the proposals this should not necessarily be read by the Commission services as a general agreement of all CEBS members with those proposals put forward. Some CEBS members may still have (national) comments/concerns which they may wish to submit to the Commission services separately.

Liquidity standards (section I of the Consultation Paper)

General remarks

4. Section I concerning liquidity regulations proposes two regulatory standards for liquidity risk, as well as a set of common monitoring tools which could be established in legislation. The proposals from the Commission services are based on recent proposals from the Basel Committee. The latter are developed for large international banking groups; therefore CEBS proposes to elaborate more on the proportionality principle in the CRD IV.

5. The liquidity coverage ratio is based on stress scenarios and will be described in detail in the legislation. CEBS likes on a general basis to underline that conducting stress tests should play an important role in the institutions liquidity risk management. It is of great importance that the supervisors make sure that the institutions not only mechanically perform stress tests described in the legislation, but carry out as well institution specific ones based on individual assumptions and scenarios that reflect the business structure and the inherent risk properly. This is already covered by Annex V of CRD II, on organisation and treatment of liquidity risk, section 10, point 20 " Credit institutions shall

consider the potential impact of institution- specific, market – wide and combined alternative scenarios. Different time horizons and varying degrees of stressed conditions shall be considered."

6. Both standards, the short-term Liquidity Coverage Ratio (LCR) and the long-term Net Stable Funding Ratio (NSFR) will be requirements that credit institutions have to fulfil at all times. CEBS agrees with the proposed text in the section I paragraph 3 that however clearly states that under stress, credit institutions could fail to meet the requirements and that in such circumstances credit institutions would be required to restore compliance over a short timeframe. CEBS agrees that competent authorities in such cases should be required to define a restoration plan and to follow up its implementation.

Liquidity Coverage Ratio

7. CEBS has on several occasions focused on the importance for institutions to have sufficient liquidity buffers to be able to withstand stress. Recommendation 16 in CEBS's technical advice to the European Commission on liquidity risk management (CEBS 2008 147) states: "Liquidity buffers are of utmost importance in time of stress, when an institution has an urgent need to raise liquidity within a short timeframe and normal funding sources are no longer available or do not provide enough liquidity. These buffers, composed of cash and other highly liquid unencumbered assets should be sufficient to enable an institution to weather liquidity stress during its defined 'survival period' without requiring adjustments to its business model."

8. CEBS's "Guidelines on Liquidity Buffers and Survival periods" (December 2009) give further guidance to the institutions on the short end of the counterbalancing capacity, focusing on size and composition of liquidity buffers to enable institutions to withstand a liquidity stress for a period of at least one month without changing their business models.

9. The Commission services propose a LCR requiring credit institutions to match net liquidity outflows during a 30 day period of acute stress with a buffer of "high quality" liquid assets.

10. The proposal is based on a stress scenario that will be defined in the legislation with specific rates for outflows and inflows for each major balance sheet item. High market liquidity is the key criterion for the eligibility of assets for the liquidity buffer. The determination of these assets is based on fundamental and market-related characteristics that constitute high quality liquid assets as described in the CP. As a result the definition does not only focus on cash and high quality government bonds. As an additional characteristic, the liquidity buffer assets should be eligible as collateral for central bank credit operations.

11. CEBS notes this approach based on defining characteristics of high quality liquid assets. This is consistent with the approach taken in CEBS Guidelines on Liquidity Buffers and Survival periods, Guideline 4: "The liquidity buffer should be composed of cash and a core of assets that are both central bank eligible and highly liquid in private markets [for the shorter end of the buffer, ie at least one week]. For the longer end of the buffer[ie at least one month], a broader set of liquid assets might be appropriate, subject to the bank demonstrating the ability to generate liquidity under stress from them within the specified period of time."

CEBS wonders however if the text in paragraph 7 in the CP, third sentence, adding the central bank eligibility as a necessary additional criterion would convey the message that the Commission services want to narrow down the list of liquids assets, as the proposed ratio is at one month time horizon.

12. Banks should be able to demonstrate the ability to generate liquidity from the liquidity buffer assets under stress within a short period. Nonetheless CEBS (future EBA) stands ready to develop further technical standards specifying the list of eligible collateral for liquidity purposes as mentioned in paragraph 7 of the CP.

13. CEBS agrees with the Commission services that further analyses of the trade-off between the severity of the stress scenario and the definition of the stock of liquid assets is needed, based on the consultation and the EU quantitative impact study (QIS) now under way. CEBS will as an example on necessary further considerations point to the specific requirements mentioned in Annex I for "additional" assets (corporate bonds and covered bonds) which could be considered for up to 50 % of the buffer. There is a question whether some of the mentioned criteria are so far fetched (e.g. the criteria regarding bid-ask-yield spreads) that in practice all "additional" assets will be excluded. In this context CEBS would like to draw the attention of the Commission services to the relevant Guideline 5 in its Guidelines on Liquidity Buffers and Survival Periods "Credit institutions need to manage their stocks of liquid assets to ensure to the maximum extent possible that they will be available in times of stress. They should avoid holding large concentrations of particular assets, and there should be no legal, regulatory, or operational impediments to using these assets."

14. CEBS will also underline that EU liquidity regulations have to relate to and take into consideration specificities regarding EU members national markets for sovereign debt, as well as private debt, including covered bonds (such as market size, depth and concentration). The covered bonds issue is of particular importance throughout Europe. The final calibration of the in- and outflow percentages and haircuts should take into account the results of the current EU QIS. In the calibration the Commission services could also consider the possibility of increasing the percentage of high quality covered bonds which easily fulfil all listed criteria. The calibration should create strong incentives for institutions to strengthen their funding profile but should not be overly restrictive due to possible negative macro economic impacts. CEBS especially points to high impact for national and international money and bond markets as well as high implementation costs for banks, should the narrow definition of liquid assets be adopted for the liquidity coverage ratio.

15. In the same vein, one of the EU specificities is that investment firms are covered by the CRD. CEBS strongly recommends that only the most systemic important and/or leveraged investment firms should be subject to the liquidity standards. In practise this would mean that the majority of these firms should be exempt from quantitative requirements.

16. CEBS notes that the Commission services highlight that the institutions should be able to meet their liquidity needs in each currency, but that there will not be a requirement for the institutions to calculate the LCR per currency. The adequate currency distribution of buffer assets should be left to institutions, subject to supervisory review.

Net Stable Funding Ratio

17. CEBS appreciates the introduction of a long-term Funding Standard which takes into account assets and liabilities. The Net Stable Funding Ratio should contribute to reduce the reliance on short-term wholesale funding and ensure a more stable funding structure. Nevertheless, the calibration of such a ratio, including its time horizon, should be carefully assessed through the analysis of the results provided by the QIS.

Completeness of legislative approach

18. Annex I and II of the CP define the composition of the two liquidity standards based on percentages specified which mark a conservative floor. The CP states that in addition there could be national specificities which require other specific parameters (higher run off rates for certain sub categories of deposits have been mentioned as examples). CEBS (future EBA) stands ready to work out technical standards for the numerous parameters which can include specific national ones. Such technical standards could secure transparency with a periodically and timely update and are due to their flexibility more appropriate than the inclusion of the parameters in the CRD. In many cases, the delineations of items in Annex I and Annex II do not correspond to legal definitions of product categories in the Member States. CEBS proposes to develop functional definitions to ensure that all instruments that have the same liquidity risk characteristics are treated alike. In addition, such functional definitions would be more flexible then legal definitions to keep pace with financial innovation.

19. To foster a degree of simplicity, reduce possible arbitrage and create a level playing field for the institutions, CEBS however suggests that the amount of national specific parameters should be kept at a reasonable level.

Scope of application

20. The CP proposes in paragraph 16 that the appropriate level for the application of the two liquidity requirements might be:

- Credit institutions (both parent and subsidiaries) on an individual "stand-alone" basis plus
- EU parent credit institutions (as defined in Article 4 (16) as a parent that is not a subsidiary of any other credit institution within the EU) on a consolidated level.

21. In paragraph 17 the CP proposes that there should be an opportunity for the institutions to use a waiver to derogate from the stand-alone requirement based on certain conditions described in the CP. A vast majority of the CEBS members welcome to allow for waivers, especially national ones, where the conditions could be more flexible when the subsidiary is situated in the same country than the parent company. The proposal that waivers for legal entities located in different Member States should only be granted on a joint agreement between the consolidating supervisor and the competent authority responsible for the supervision of the foreign subsidiary seems to be appropriate. This should in an adequate way give the host supervisors the possibility of determining the role and responsibility they want to have in the supervision of local subsidiaries.

22. The Basel framework which forms the basis for the proposals from the Commission services is prepared for large international active institutions. The intention in the proposal from the Commission services is that the liquidity standards should apply for all types of credit institutions, regardless of size or business model. The EU QIS will include data from different types of institutions including small and medium sized banks. A vast majority of the CEBS members find it important that the situation for the smaller banks should be taken into due consideration when working out the final proposal and implementation of the EU liquidity regulations (see our comment in paragraph 2 above). Furthermore, the CRD should take due regard of the specific ownership structure of decentralised sectors (ie mutual banks… etc.).

23. CEBS stands ready to make necessary preparations so that EBA in the future might be called upon to settle possible disagreements between supervisory authorities regarding use of waivers, as proposed in paragraph 18 of the CP. The reference in this paragraph – "likely to involve substantial changes in terms of insolvency and company law along the lines outlined in the October 2009 Commission services' communication on "an EU framework for cross-border crisis management in the banking sector …" – should be deleted, as it might be misinterpreted as ruling out cross-border waivers for years to come.

Treatment of intra-group transactions and commitments

24. A vast majority of the CEBS members appreciate the outline and description of different alternatives for the treatment of intra-group transactions and supports a symmetrical treatment of intra-group flows. In paragraph 23 of the CP, a flexible approach is described with a possibility for supervisory authorities to honour intra-group transactions. However, as several CEBS members think it is too early to have a firm stand on this topic, we think it is worthwhile to wait for the results from the QIS to shade light on effects on the liquidity standards from applying alternative treatments of intra group transactions.

Monitoring Tools

25. CEBS welcomes the introduction of harmonised monitoring tools. Due to flexibility and timely update such monitoring tools should be incorporated into technical standards and not in the CRD similar to the proposal for the parameters for the LCR and the NSFR. Moreover, there are differences in the building of the tools between the Commission services' proposal and the Identity Card provided by CEBS. CEBS would like to call the attention of the Commission services to the tools that are already under implementation across the EU based on the CEBS Liquidity Identity Card. Additional monitoring tools would lead to a multiplication of work for the competent authorities and for banks without additional benefit. Thus, CEBS is ready to provide guidance concerning the consistent implementation of monitoring tools across the EU.

26. Finally, the question of transparency is not mentioned in the Commission services' proposal, and CEBS would like to call for a cautious approach, as far as the transmission to the market of a lot of elements, not thoroughly understood by the market participants could have a procyclical bias. In its approach of the Identity Card, CEBS proposed to let the monitoring tools for the use of the college of supervisors.

Definition of capital (section II of the Consultation Paper)

27. CEBS has published in December 2009 its final guidelines on hybrid capital instruments and its draft guidelines on instruments referred to in Article 57(a) of the CRD (CP 33).

28. CEBS has conducted in November 2009 a preliminary limited quantitative impact assessment aiming at assessing if the current Basel Committee (BCBS) discussions on the definition of capital could create any difficulties to the European credit institutions.

29. Both the two sets of guidelines and the preliminary limited quantitative impact assessment form the basis of CEBS's comments on the Definition of capital section of the Commission services' Consultation Paper.

30. CEBS welcomes the statement made in the Consultation Paper that, in making further revisions to the CRD's own funds requirements, the Commission services will consider the guidelines issued by CEBS and the potential need for further additional guidance in this area from CEBS.

31. With this in mind, CEBS considers as highly desirable that the principles elaborated in its current guidelines on capital be reflected to the greater extent possible in the final CRD IV proposals. A thorough work has been conducted by CEBS over the past years on capital and hybrid instruments. Europe has developed at an early stage criteria for convergence and quality of own funds thanks to CRD II provisions and CEBS guidance. This work has to be taken into account in the final CRD IV proposed changes to complement the criteria defined by the BCBS where necessary.

32. CEBS comments focus on the aspects that appear to be the most important ones and that have already been discussed among CEBS Members. Other aspects (e.g. gone concern capital provisions, contingent capital) will have to be discussed further between CEBS Members and with the Commission services within the technical CRDWG capital Sub-group.

33. CEBS has noted that the CEBS QIS will be used by the Commission services to determine the appropriate calibration for the minimum levels of the ratios of Core Tier 1, Tier 1 and total capital to risk-weighted assets as well as for the required level of predominance of Core Tier 1 and appropriate grandfathering and transitional provisions.

Core Tier 1 capital

34. In CEBS's view, regarding the definition of capital, the CRD text as amended by CRD II is largely compliant with the BCBS proposal. CEBS's draft guidelines on Article 57a provide detailed guidance on the implementation of the current CRD provisions as amended by CRD II.

35. In this regard, CEBS finds it highly desirable that the Commission services introduce in a more explicit manner in the final CRD IV proposal the principles laid down in the guidelines on Article 57a instruments (once the final guidelines are published).

36. CEBS appreciates that the Commission services consider it appropriate that non-joint stock companies' capital instruments of the highest quality be recognised as Core Tier 1 capital.

37. Nevertheless, CEBS's view is that **the final proposal should rely in a more extensive way on the detailed guidance elaborated by CEBS that notably clarify to which extent the specificities of non-joint stock companies** may be taken into account. In particular, the Directive should make it clear that non-joint stock companies' capital needs to meet both the permanence and flexibility of payments principles, as well as the loss absorbency one.

38. **The same holds true concerning CEBS's stance on redemptions and buy-backs** of core capital instruments that shall be subject to a prior supervisory approval.

39. Finally, CEBS has noted that instruments providing preferential rights for dividend payment, currently eligible in Core Tier 1 capital under Recital 4, would not be eligible anymore under the new CRD IV provisions. This would ensure consistency with the proposals discussed at the international level (BCBS).

Non-Core Tier 1 capital

40. CEBS appreciates that the Commission services has taken up some of the criteria defined by CEBS in its guidelines on hybrid instruments (especially on loss absorbency mechanisms) when considering further changes to CRD provisions on Non-Core Tier 1 capital.

41. However, CEBS is concerned that the forthcoming changes may not require instruments that qualify as equity for the purposes of insolvency law to have a meaningful loss absorbency mechanism like a conversion or write-down feature.

42. As stated in its guidelines on hybrid capital instruments, and in order to strengthen the non-core capital base, CEBS considers that hybrid instruments must contain a meaningful statutory or contractual loss absorbency mechanism (conversion into a core capital instrument or write-down of the principal) that will make the recapitalisation more likely by reducing the potential future outflows to the hybrid holders at a prudent and timely enough trigger point.

43. To this regard, CEBS fully agrees with the Commission services' view in paragraph 52 of the Consultation Paper that it is vital that all forms of going concern capital absorb losses effectively on a going concern basis.

44. Thus, CEBS deems it necessary that **all hybrid instruments, regarded as equity or as liabilities for the purposes of national insolvency law, have a meaningful loss absorbency mechanism (conversion or write-down feature)**. In fact, the treatment of an instrument under national insolvency law may not always be a relevant factor across jurisdictions, hence reinforcing the importance that all hybrids should have such meaningful mechanisms irrespective of such law. Should this not be required under the upcoming CRD IV provisions, the quality of instruments included in non-core Tier 1 would fall behind the requirements set forth by CEBS's guidelines on hybrid capital

instruments with regard to the ability of the instruments to absorb losses in going concern situations and not to hinder the recapitalisation.

45. As laid down in its guidelines on hybrid instruments, CEBS considers that the issuer or the competent authority shall be able to activate the aforementioned mechanisms within a manageable timeframe and certainly when a breach of the minimum capital requirement set out in Article 75 of the CRD (currently 4% Tier 1 ratio and 8% total capital ratio) is about to happen.

46. With this in mind, CEBS supports the Commission services' comment that an element of discretion (in CEBS's view, such as a decision by the regulator or the credit institution) has a potentially useful role to play in triggering conversion.

47. Furthermore, CEBS is fully in line with the Commission services' view that **no additional eligibility requirements in relation to the tax treatment of hybrid instruments are to be required**. The tax treatment does not form part of CEBS's guidelines on hybrid capital instruments. The tax treatment of hybrid instruments has indeed not to be taken into account when assessing Non-Core Tier 1 eligibility criteria.

48. As stated in CEBS's guidelines on hybrid instruments, permanence of capital instruments is an important criterion. Ability to redeem and buy-back hybrid instruments has to be strictly limited and monitored. In order to increase the permanence of Non-Core Tier 1 capital instruments, CEBS agrees that instruments with incentives to redeem should be excluded from Non-Core Tier 1 capital.

49. Finally, the treatment of features that CEBS considers as acceptable in its guidelines on hybrids with regard notably to flexibility of payments (e.g. dividend pushers) will need to be further assessed and reflected in the final proposals from the Commission services.

Prudential filters and deductions

50. CEBS takes note that the Commission services consider it appropriate that prudential filters and deductions be made generally in respect of Core Tier 1 capital.

51. CEBS fully agrees with the Commission services that the overall effect of the proposed treatment of prudential adjustments will have to be reviewed as part of the impact assessment, as well as potential alternative approaches to the treatment of certain aspects, including minority interests, deferred tax assets, investments in other institutions and insurance companies and unrealised gains and losses. In addition, it is worth recalling that the accounting standard IFRS9 relating to classification and measurement of financial instruments has not been endorsed by the European Commission yet. Future impacts of this standard on prudential filters would also need to be assessed.

52. Depending on the results of the impact assessment, appropriate transitional provisions with a pre-determined period of time for credit institutions to comply with the new rules may be considered, including a potential application of different transitional periods depending on the type of capital-related measure.

53. Based on the preliminary limited quantitative impact assessment conducted during the fourth quarter of 2009, **CEBS sees indeed several causes for concern**.

Minority interests

54. CEBS Members whose jurisdiction host significant subsidiaries have **concerns about the exclusion of minority interests from Core Tier 1 capital**. Hence, there is indeed a general concern about the potential impact of this deduction on the behaviour of the Parent bank in relation to the capitalisation of the subsidiaries with a result that, in a longer term, the subsidiaries could lose excess capital.

55. In general, CEBS feels that the exclusion of the full amount of minority interests from Core Tier 1 capital does not fully recognise that minority interests can effectively support risks at the level of the related subsidiaries. Possible options for alternative treatment should be therefore further considered. For example, the recognition in Core Tier 1 capital of minority interests up to the amount of the capital requirement of the subsidiary that is proportionally covered by minority interests could be considered. Some CEBS Members consider that another potential option could be to adopt a symmetric approach, whereby, as the minority interests are excluded from Core tier 1, then the risks associated with the minority interests are also to be excluded from the risk weighted assets of the Core tier 1 ratio.

Deferred tax assets

56. The amount of deferred tax assets is expected to increase during a crisis. While there are arguments for not allowing deferred tax assets in general in Core Tier 1 capital, there are also arguments concerning a potential procyclicality effect of the deduction of deferred tax assets from own funds that **needs to be assessed.**

57. Moreover, the amount of deferred tax assets will be different between countries depending on the extent to which tax treatments differ compared to accounting treatment. This may create an uneven playing field between countries. The sources of deferred tax assets should be assessed carefully before deciding on the prudential treatment.

58. In some countries, a substantial amount of deferred tax assets relates to the fact that credit risk provisioning is tax deductible only once the losses have effectively incurred. If supervisors wish to promote provisioning in accounting at an early stage, this may result in a potential increase in the amount of deferred tax assets. While acknowledging that entities should ensure compliance with specific accounting standards relating to provisioning, we caution against a level of deduction of deferred tax assets which might be a disincentive to provisioning at an early stage.

59. Based on the results of the impact assessment in progress, options like for example a certain non-deductible threshold level of Core Tier 1 could be considered. As already indicated and subject to compliance with accounting

standards, **the rationale for an appropriate treatment is the need for not discouraging banks from making credit provisions, even if not tax-deductible, and not creating an uneven playing field,** taking into account the tax effects on filters and deductions.

Investments in other institutions and insurance companies

60. The deduction of the full amount of participations in other financial institutions and insurance companies from Core Tier 1 capital would have **a significant impact in some European countries where banking groups have substantial participations in banking and/or insurance sectors**.

61. CEBS would welcome a clarification on the way the proposed treatment in the case of holdings in insurance companies would articulate with the existing treatment of such participations under the provisions of Articles 59 and 154.4 of the CRD and with Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms **in a financial conglomerate** and within the context of the European bancassurance business model. These provisions have been operational for several years in European countries and deemed to be an efficient framework to avoid double counting of capital in the financial system.

62. Furthermore, CEBS and CEIOPS have just recently set up a workstream within the Joint Committee on Financial Conglomerates (JCFC) to develop guidance in relation to the treatment of cross-sectoral participations under the Financial Conglomerates Directive (FCD), following their advice on the FCD submitted to the EC in October 2009. Therefore CEBS recommends that the Commission services take the results of this work into account when reflecting on the treatment of participations.

Unrealised gains and losses

63. The treatment of unrealised gains and losses requires further thought from CEBS in light of the current revision of the international accounting rules (IFRS). In that respect, the full recognition of unrealised gains in Core Tier 1 capital raises some supervisory concern notably when these gains relate to assets that are insufficiently liquid and/or when valuation models are used (level 2/ level 3 fair values). In this case, unrealised losses may also be non-reliable. CEBS still needs to consider whether there is a need for adjustments of these (or parts of these) elements to address these concerns.

64. In case the removal of the current prudential filters on unrealised losses on current AFS assets were to be decided, this could lead to significant impacts in some banks and therefore would necessitate considering appropriate transitional measures.

Grandfathering and transitional provisions

65. One of CEBS's paramount concerns is the elaboration of appropriate grandfathering and transitional provisions. It is indeed vital to avoid a bypassing of the objectives of the reforms intended through CRD II and CRD IV changes as

well as opportunistic behaviours from credit institutions trying to exploit the current uncertainty surrounding grandfathering and transitional provisions both at European and international levels. Concrete technical proposal will thus have to be defined in a relatively short period of time.

66. CRD II provisions have to be implemented at the end of 2010. CRD IV forthcoming changes will amend some of CRD II provisions on the features of eligible instruments and on the eligibility of others (e.g. instruments with incentives to redeem) or on the applicable limits for non-core capital instruments in terms of Tier 1 capital. **This raises practical issues relating to grandfathering**.

67. At the same time, CRD current provisions on grandfathering do not explicitly clarify the way to treat grandfathered instruments for the first ten years after CRD II enters into force.

68. Suitable arrangements should be found out to **ensure consistency and avoid regulatory arbitrage** in the implementation of CRD II grandfathering provisions, taking due account of the forthcoming CRD IV reform. This should be foreseen in the short term given that CRD II provisions have to be applied beginning December 2010.

69. Several aspects related to grandfathering will have to be reflected on in the forthcoming changes, in sufficient detail to avoid room for interpretation and to promote a convergent implementation between Member States. For example:

- Potential impact on the provisions to be applied beginning 31 December 2010 till CRD IV enters into force;
- Provisions to be applied at the time CRD IV enters into force;
- Application of different grandfathering provisions depending on the type of capital-related measure or capital instrument;
- Need to maintain capital instruments in their original capital buckets or to downgrade them into lower quality capital buckets;
- Length of the grandfathering period: grandfathering for a pre-set time, until the first call date of the instruments, gradual amortisation plans, etc;
- Specific grandfathering treatment for instruments subscribed by governments and interaction with the exit strategy;
- Common supervisory action before the final rules are agreed in order to detect any banks' strategies aiming at increasing the amount of instruments that could be grandfathered during this interim period.

70. CEBS acknowledges that a concrete proposal cannot be elaborated prior to the analysis of the QIS results. Once these are available CEBS envisages to elaborate guidance on grandfathering to be submitted to the Commission in due course.

Contingent capital

71. CEBS has noted that the Commission services will reflect further on the potential role and characteristics of contingent capital and on the potential triggers for conversion to potentially go beyond the existing CRD provisions for instruments that must be converted into Core Tier 1 capital in emergency situations or at supervisory discretion.

72. Contingent capital has to be further discussed between CEBS Members and CEBS wishes to work further with the Commission services on this aspect within the technical CRDWG capital Sub-group.

Leverage ratio (section III of the Consultation Paper)

73. CEBS welcomes the consultation of the Commission services and supports its work in exploring further the design and calibration of the leverage ratio. CEBS highly appreciates that the Commission services consider that the results of the IA will be essential for the final design and the calibration of the leverage ratio.

74. At this stage CEBS does not wish to comment on the design and calibration of the ratio in addition to what was mentioned in its reports to the Commission on the outcome of the back-testing exercises. However, CEBS would like to highlight that, if introduced, it is essential that the leverage ratio is consistently defined and implemented across countries to maintain a level playing field for institutions. It is crucial that the material differences in the accounting standards (for example the important differences in the treatment of netting for derivatives and repos and of derecognition of assets for securitisation between IFRS used in the EU and the GAAP used in the US) are fully taken into account in the design and potential implementation of the leverage ratio.

75. It is also essential that the leverage ratio is neutral towards the business models of banks. Some members of CEBS fear that introducing a leverage ratio into prudential regulation as a one-size-fits-all back-stop measure may have unwanted effects on the activity of potentially a large number of credit institutions. Those members strongly support the approach of including the leverage ratio as part of the Pillar 2 process.

76. CEBS stands ready to contribute to the further work on the design and calibration of the leverage ratio.

Countercyclical measures (section V of the Consultation Paper)

Part 1 - Through-the-cycle provisioning for expected credit losses

General comments

77. As regards the Commission services' proposals for countercyclical measures, in particular through-the-cycle provisioning for expected credit losses, CEBS would like to offer the following views.

78. More generally CEBS is of the view that the current incurred loss model as set out in IAS 39 does not fully reflect the way in which banks manage credit risk, since credit risk provisions are not recognised early enough in the financial statements. This means that lending losses can have procyclical effects.

79. CEBS therefore welcomes a change in current accounting rules that would allow provisions for lending losses to be made earlier, thus mitigating procyclicality.

80. Although CEBS is still considering the details of the IASB's expected cash flow (ECF) model, we feel that, at the conceptual level, this better reflects the economic reality of banks' lending activities than the incurred loss approach in that it requires an earlier recognition of expected credit losses.

81. How the ECF model will reflect the credit risk borne at portfolio level and already incurred credit losses, and at the same time address procyclicality concerns, will depend both on the IASB's final design of the model (which is currently subject to an eight month consultation period) and the ability of firms to accurately assess expected credit losses over longer time horizons.

82. CEBS sees the merits in the work done by the Commission services to provide constructive input to the debate on provisioning. However CEBS has a preference for waiting for the IASB to complete its standard on impairment before dealing with the question of whether there is a need for an additional complementary approach, and what this approach should be. That will avoid overlapping work and potentially inconsistent developments.

83. Furthermore, the Commission services should ensure that the developments that are currently being undertaken in Basel and in other fora are being considered in order to maintain a level-playing field with non-EU countries.

Question 38: The Commission Services invite stakeholders to perform a comparative assessment of the three different methods (i.e. ECF, incurred loss and IRB expected loss if it could be used for financial reporting) for credit loss provisioning from 2002 onwards based on their own data.

84. CEBS has not performed a quantitative assessment of the three models. However, CEBS has made the following qualitative comparison of the three methods (although it will further review the ECF model, in line with the IASB's extended consultation period).

Current incurred loss method

85. As banking supervisors, CEBS is of the view that the current incurred loss model - by linking the establishment of a provision to a trigger event - is too restrictive and, most importantly, not fully consistent with the manner used to manage credit risk by banks. This is because credit risk provisions under an incurred loss model are not usually recognised until a later stage in the lifetime of bank credit, while banks manage credit risk at a portfolio level charging a risk

premium for expected losses from inception. Current accounting rules based on incurred losses therefore tend to create a cyclical pattern in banks' earnings from lending activities, with impairment provisions appearing at low points in the economic cycle when defaults cause the risk to crystallise.

IASB ECF method

86. Although CEBS's discussions on the ECF model are still underway, our initial views are that, conceptually, this method achieves a more timely recognition of expected credit losses than the current incurred loss accounting model. It could also be less cyclical. Reduced cyclicality depends on i) whether credit risk factors based on long data series are applied, and ii) whether the requirement to re-measure the carrying value of loans 'triggers' when expectations of loss change. Efforts should in the meantime be undertaken to ensure the IASB addresses procyclicality concerns as much as possible, by considering for example the use of through-the-cycle rather than point-in-time estimates.

87. There are also considerable operational challenges which are currently being discussed, along with potential simplifications, in many different fora, most notably the IASB's Expert Advisory Panel.

IRB expected loss model

88. CEBS understands the revised proposal by the Commission services for IRB banks is based on an adaptation of the provisioning approach implemented in Spain by the Banco de España. The Commission services' proposal would allow banks with permission to use internal ratings-based models for capital purposes to use the same model to calculate through-the-cycle expected loss provisions. This would entail estimating expected credit risk losses over the economic cycle, thereby dampening the impact of cyclical developments on net income. It aims first of all to recognise that banks charge a risk premium for credit losses since inception, and secondly to correct a bank's perceived over-optimistic view on credit losses in its accounting figures during an economic upturn or an expansion of the credit risk portfolio (exacerbated by competitive pressures and investment trends).

89. As suggested by the title of section V. the Commission services' proposal aims to be explicitly counter-cyclical (thereby implicitly recognising the economic judgements noted immediately above) unlike either the incurred loss model or the IASB's ECF model.

Question 39: Views are sought on the suggested IRB based approach with respect to the through-the-cycle provisioning for expected losses as outlined above.

90. CEBS agrees that this proposal has merits due to its counter-cyclical nature, in allowing an adequate reflection of credit losses over the whole economic cycle.

91. However, CEBS notes the following issues arising from the Commission's consultation:

- The Commission services' proposal raises a timing issue. As already stated, CEBS has a preference for postponing any decision in this area because the IASB has not finalised its work on the revision of the impairment model and is currently in discussions with the Basel Committee. Moreover such a measure will be difficult to implement in a downturn and any such measure will take some time to have an impact.

- The Commission services' proposal for an IRB expected loss approach introduces the measure "net specific provision for non performing loans". Information on specific provisions for non-performing loans is relevant not only to users of financial statements but also for purposes of credit risk management, but its articulation within an ECF model needs to be clarified.
- It is not clear whether the approach proposed by the Commission services considers only the annual flows of expected losses (1 year) and actual losses, without taking into consideration the adequacy of the stock of general provisions in comparison with the expected losses over the residual life of loans. Before going ahead it is important to consider the exact workings of such an approach.
- Further consideration will be needed to ensure that any approach is workable both for banks using the IRB approaches and banks using the standardised approach as the latter group forms a material part of the EU financial sector.
- It is questionable in this context whether a change in the prudential system would be sufficient to implement the method proposed by the Commission, or whether there would also be a need to amend the European accounting framework. This could result in additional differences between IFRS (as adopted in the EU) and the original IFRS (as promulgated by the IASB), which could raise level-playing field issues with regard to non-EU countries.
- Developing appropriate disclosure requirements around any provisioning framework will be important to ensure that the adjustments made are transparent for users of accounts. Where measures are implemented in different frameworks (including the CRD and IFRS), alignment of disclosure requirements as far as possible should be considered so as to avoid undesirable complexity.

92. CEBS also agrees that further work would be needed on the technical issues raised in paragraph 148.

93. Finally, CEBS feels that there is a need for field testing and an impact assessment of this approach before an informed decision on the next steps is possible.

Part 2 - Capital buffers and the cyclicality of minimum requirements

94. CEBS welcomes the consultation of the Commission services and agrees that the issue of the cyclicality of the minimum capital requirements needs to be addressed. CEBS supports further work on the definition of instruments which will move in a counter-cyclical fashion to capital levels of banks, by increasing during economic upturns and decreasing in downturns.

95. CEBS recalls that it has provided a preliminary contribution to the debate on pro-cyclicality by outlining possible practical tools for supervisors to assess banks' capital buffers under Pillar 2. The outcome of this work is set out in a Position Paper on a countercyclical capital buffer, which was published in July 2009.[1]

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[1] Position Paper on a countercyclical capital buffer: http://www.c-ebs.org/News--Communications/Archive/2009/CEBS-today-publishes-a-Position-Paper-on-a-counter.aspx

96. The focus on Pillar 2 ensures that buffers are: i) sufficiently flexible, ii) determined as the result of the dialogue between institutions and competent authorities and iii) not seen as simply permanently raising the existing minimum capital requirements. Moreover, Pillar 2 allows for flexibility in testing approaches.

97. The position paper focused on the cyclicality of credit risk in the banking book of IRB banks as these banks cover a substantial share of banking assets and as the use of internal models makes them more prone to pro-cyclical effects.

98. The mechanisms presented in the position paper are based on the differences between the probabilities of default estimated by banks in an economic recession/downturn and currently applied probabilities of default. Two options were presented for the calculation of the buffer:

- A portfolio level option
- A rating-grade level (i.e. more granular) option